

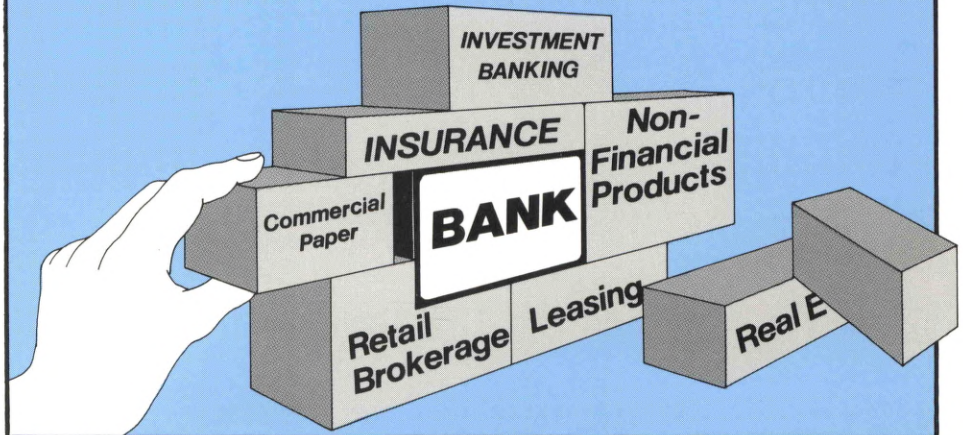
BUSINESS REVIEW

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Federal Reserve Bank of Philadelphia
JULY • AUGUST 1988

Banking Reform: An Overview of the Restructuring Debate

Mitchell Berlin



Thinking About The Deductibility of State and Local Taxes

Harvey S. Rosen

Form 1040 Schedule A - Itemized Deductions

If you need more information, turn to the page shown in the circle.

Schedule A (Schedule B is on back)

Attach Form 1040-A to your Form 1040 for Schedules A and B (Form 1040).

Your social security number: 516-00-1492

1a Prescription medicines and drugs, including doctors' fees, nurses, hospital care, dental care, etc. 2,514.00

1b Transportation and lodging 50.00

1c Other (list—include hearing aids, eyeglasses, etc.) 28.00

2 Add lines 1a through 1c, and enter the total here: 2,592.00

3 Multiply the amount on Form 1040, line 31, by 5% (0.05) and enter the result here: 129.60

4 Subtract line 3 from line 2. If zero or less, enter -0-: 2,462.40

5 State and local income taxes

6 Real-estate taxes

7 Other taxes (list—include personal property taxes) 2.74

Total taxes 2,510.00

8 Add the amounts on lines 5 through 7. Enter the total here: 400.00

Note: If you borrowed any new amounts against your home mortgage interest in 1987 the total of all your debts was more than what you paid for your home mortgage interest you paid to financial institutions, attach Form 8538 and check here (eligible points on line 10).

9a Interest you paid to individuals 53.00

9b Total interest

10

11

12b Total interest

Taxes You Paid (See instructions on page 22.)

Medical and Dental Expenses (Do not include expenses reimbursed or paid by others.) (See instructions on page 21.)

Frank and

DULES A&B (Form 1040)

Department of the Treasury Internal Revenue Service

Amount(s) as shown on Form 1040

Attach Form 1040-A to your Form 1040 for Schedules A and B (Form 1040).

BUSINESS REVIEW

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JULY/AUGUST 1988

This issue of the BUSINESS REVIEW addresses two controversial topics: banking reform and the deductibility of state and local taxes for federal tax purposes. Both topics have been hotly debated, with analysts so divided on certain aspects of both that everyone might not agree on the descriptions of all the issues presented here. But to begin to understand the debates about these topics, it helps to identify some of the key questions underlying the disagreements about the issues.

BANKING REFORM: AN OVERVIEW OF THE RESTRUCTURING DEBATE

Mitchell Berlin

Financial markets have undergone many changes in recent years, and many bankers and bank regulators say a refashioning of the current regulatory structure is now in order. Most of the proposals for doing so agree that bank powers should be expanded, that "functional regulation" is desirable, and that a safety net for banks should be retained. Important disagreements remain, however, over *how far* bank powers should be expanded, how banking organizations with expanded powers should be regulated, and what types of corporate structures are desirable. These disagreements stem largely from differences of opinion about whether banks can be adequately insulated from their nonbanking affiliates.

THINKING ABOUT THE DEDUCTIBILITY OF STATE AND LOCAL TAXES

Harvey S. Rosen

In writing the Tax Reform Act of 1986, lawmakers were faced with the politically sensitive issue of whether to retain the deductibility of state and local taxes. In doing so, they had to consider two questions. First, should the money people use to pay state and local taxes be included, in principle, in the tax base? Second, how would state and local finances be affected if deductibility were eliminated? The answer to the first question depends on how income is defined in an economic sense, the answer to the second on how individuals and communities make decisions on taxes and public spending.

Banking Reform: An Overview of the Restructuring Debate

*Mitchell Berlin**

Proponents of banking reform, whether they be bankers, nonbank bankers, would-be bankers, or bank regulators, all agree on one thing: our current regulatory system is out of sync with the financial marketplace. Proponents of reform point out that regulatory restrictions prevent a firm that might be able to provide a financial service to customers at lowest cost from competing for customers' business, and that services that fill

the same customer needs and pose very similar risks—like making short-term loans and underwriting commercial paper—often cannot be provided by the same firm. They also have argued that as customer demand shifts from one product to another, financial firms frequently face a dilemma: to seek out ways to evade regulations or else to lose business.

Policymakers have tinkered with regulations and patched loopholes in response to marketplace changes, but this piecemeal approach always seems to leave regulators one repair behind, because financial changes have been so rapid. And each repair is time-consuming, both because

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of the amount of time required to analyze the issues being raised in each case and because many industry groups seek to influence the final outcome. There is a growing feeling that it is time for a more fundamental financial restructuring, guided by a longer-term blueprint. Reform would be made more coherent if public debate could be focused on a longer-term vision of a workable and efficient regulatory framework.

There is no shortage of complicated restructuring plans (see A BIBLIOGRAPHIC GUIDE TO THE RESTRUCTURING PROPOSALS), and evaluating the merits of the different proposals may seem like a daunting task. A helpful first step is to identify and explain the broad areas of agreement and disagreement among the various plans. Indeed, most participants in the debate

agree that bank powers should be expanded and that a limited safety net for banks should be retained. There is, however, much disagreement about what powers banking organizations should have, what types of holding company structures — if any — are desirable, and how holding companies should be regulated. While the disagreements are far-ranging, they stem primarily from disagreement about a single issue: can a bank be insulated from its affiliates?

THREE BROAD AREAS OF AGREEMENT

Bank Powers Should Be Expanded. All the restructuring proposals agree that some expansion of bank powers would not only enhance the competitiveness of banks in financial markets but would also benefit consumers and businesses.

A Bibliographic Guide to the Restructuring Proposals

To illustrate the various points of view on restructuring the banking system, this article focuses on the following proposals made by bank regulators:

Comptroller of the Currency—The main elements of the Comptroller's views are contained in the Statement of Robert L. Clarke, Comptroller of the Currency, before the Committee on Banking, Housing, and Urban Affairs, United States Senate, May 21, 1987.

FDIC—The views of the FDIC are contained in a staff study, *Mandate for Change: Restructuring the Banking Industry*, August 18, 1987, and L. William Seidman, *Perspectives on Financial Restructuring*, Remarks to an Economic Policy Conference, Federal Reserve Bank of Kansas City, Jackson, Wyoming, August 21, 1987.

Federal Reserve System—Although the Fed has not presented a formal long-term plan, the consensus viewpoint can be gleaned from testimony by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, United States Senate, December 1, 1987. E. Gerald Corrigan's, *Financial Market Structure: A Longer View*, Federal Reserve Bank of New York, January 1987, while not an official statement of the Fed, is a good illustration of Fed thinking on many points.

Bank regulators are not the only participants in the debate. Other restructuring proposals include: Association of Bank Holding Companies, "Financial Services Holding Company Act of 1988," draft IV, May 15, 1987.

Association of Reserve City Bankers, Emerging Issues Committee, "Proposals for a Financial Services Holding Company," May 1987.

Committee on Government Operations, "Modernization of the Financial Services Industry: A Plan for Capital Mobility Within a Framework of Safe and Sound Banking," House Report 100-324, U.S. Government Printing Office, Washington D.C., 1987.

Other useful summaries of the restructuring debate include:

Thomas F. Huertas, "Redesigning Regulation: The Future of Finance in the United States," *Issues in Bank Regulation*, Fall 1987.

Manuel H. Johnson, Statement before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, May 21, 1987.

While there is no universal agreement about which products and services banks should be permitted to sell, the possibilities include financial services—such as investment banking, underwriting and selling insurance, and real estate investment and brokerage—and even nonfinancial products. The reasons for proposing expanded bank powers are varied, but tend to focus on efficiencies that might be realized.

Under the current regulatory framework, customers for financial services have to use different types of firms even though the services being purchased are closely related. Proponents of expanded powers argue that aside from facing the simple inconvenience of dealing with more than one firm, the customer might be able to purchase several services at lower cost from a single firm. For example, the credit analysis performed by a bank processing a loan request will include information that would also be useful in determining the customer's insurance needs—what economists call an economy of scope.¹ Regulations that restrict the bank from providing both loans and insurance may increase the costs of producing both services and, in turn, the price that customers must pay for them. It should be noted, however, that the empirical evidence for significant scope economies is actually rather scanty.

Bank loans and commercial paper illustrate another potential benefit of an expanded menu of services for banks that has been proposed by proponents of reform: expanded powers would ease the flow of resources between markets as customer demand changes. Many large and medium-size firms have switched from bank loans to the commercial paper market as their primary source of short-term funds. But when a firm makes the switch, the bank's accumulated knowledge about the firm is effectively destroyed

as a valuable resource, because it is difficult to sell or transfer knowledge to another firm. Thus, the firm must pay the investment banker to develop the expertise that was lost. If the commercial bank were permitted to underwrite commercial paper, this added expense to the customer could be saved and the shift to satisfy the new customer demand would be facilitated.

While the case for expanded powers is most convincing for financial services, proponents of expanded powers also argue that economies of scope between financial and nonfinancial services may also exist. All of the major auto firms have finance subsidiaries, which were initially set up to coordinate the marketing and financing of new car purchases. And the successful entry by these finance subsidiaries into the expanding markets for other types of consumer loans—such as mortgages—illustrates the potential benefits of a free flow of resources between financial and nonfinancial sectors.

Functional Regulation Is Desirable. If banks are granted powers to sell insurance or underwrite securities, policymakers must make sure that regulatory rules do not favor banks over their competitors, or vice versa. All restructuring proposals agree, at least in principle, that different types of firms providing the same service—or function—should be subject to similar regulatory rules. This principle is called *functional regulation*. Although functional regulation does not necessarily mean that all providers of a particular service should be governed by the same regulator, it may be difficult to ensure uniform regulatory treatment when different regulators are involved. And while all proposals agree that functional regulation is desirable, there is no such agreement about who should regulate which services.

Functional regulation promotes competitive equity and invites firms to use their ingenuity to satisfy customer needs rather than to evade regulations. In the competitive battle for customers, the firm with the lowest costs and best products is supposed to win. But we cannot be sure that the well-run firm will win if it is saddled with more burdensome regulatory rules than its

¹For a more thorough discussion of economies of scope, see Loretta J. Mester, "Efficient Production of Financial Services: Scale and Scope Economies," this *Business Review* (January/February 1987) pp.15-25.

poorly run competitor. In fact, the well-run firm is not likely to take this situation lying down. Instead, the firm will spend much of its time figuring out legal ways to evade the regulations that place it at a competitive disadvantage. From society's standpoint, all this time and effort are sheer waste.

A Strictly Limited Safety Net for Banks Is Needed. Deposit insurance and access to the discount window are the two main ways in which the federal authorities provide a safety net for banks and their customers. The safety net is designed to guarantee stability in the payments system and to ensure that banks can play their special role in providing liquid funds to businesses and consumers, especially in times of financial stress. But since the safety net provides government guarantees to banks and their customers, it must be supplemented by regulations to make sure that the government is not writing bankers a blank check to take on risky activities. These regulations include capital requirements and periodic bank examinations.

Most proposals agree that firms providing deposits on demand should be protected by a safety net, yet no one wishes to see government guarantees and regulations extended willy-nilly to other types of activities and services; that is, the safety net should be limited in scope. But this is easier said than done. If banks' powers are expanded, how can the government hold the safety net under the bank when it provides "banking" services without extending the net to all the other services provided by the bank? This question raises a host of vexing issues concerning how bank holding companies should be organized and regulated. Here, agreement ends and the proposals part ways.

RESTRUCTURING PROPOSALS DIFFER ON THREE MAJOR ISSUES

The institutions at issue are bank holding companies, which are firms that own one or more banks. Current law defines a bank as either a firm that offers federally insured deposits or one that offers demand deposits and makes com-

mercial loans. It is easier to see the differences among the restructuring proposals using just the first definition.

What Activities Can Be Carried out within Bank Holding Companies? Much of the immediate controversy over banking reform has been about the desirability of adding particular financial services to the bank holding company's menu of permitted activities. And, as a practical matter, only financial powers—underwriting and dealing securities, real estate investment and brokerage, and selling and underwriting insurance—are under serious consideration by federal legislators for the near future.² Each and every financial power has been hotly contested, partly because of opposition from entrenched firms who are unhappy with the prospect of new competitors, partly because of differences of opinion about the potential risks to bank safety, and partly because of different interpretations about the range of permissible powers under current banking laws. In particular, the federal bank regulators do not all agree about which of these financial services banks should be permitted. (See HOW THE REGULATORS LINE UP ON BANK POWERS.)

In the long term, however, perhaps the most important issue is whether bank holding companies should be permitted to offer just financial services or whether they should also be permitted to offer nonfinancial services and products, like automobiles. The example of a bank holding company selling cars is not unrealistic. General Motors already sells cars and also makes consumer loans. If it were permitted to offer insured deposits through its finance subsidiary, it would be a bank holding company that also produces cars.

Proposals coming from the Federal Reserve System take a narrow view of the issue of separating banking and commerce. Speaking for the

²For a summary of banking legislation before Congress, see Federal Reserve Bank of Philadelphia, *Banking Legislation and Policy*, Vol. 7, No. 1 (January/March 1988).

How the Regulators Line Up on Bank Powers

| REGULATOR | FINANCIAL | | | | | NON-FINANCIAL |
|-----------------|--------------------|-----------------------|-----------|--------------------|--------------------|--------------------|
| | Investment Banking | Real Estate | | Insurance | | |
| | | Investment | Brokerage | Underwriting | Sale | |
| Comptroller | yes | yes with restrictions | yes | yes | yes | no formal position |
| FDIC | yes | yes | yes | yes | yes | yes |
| Federal Reserve | yes | no with exceptions | yes | no formal position | no formal position | no |

Fed, Chairman Alan Greenspan has argued that banking should be separated from commerce, which is just another way of saying that bank holding companies should not be permitted to offer nonfinancial services.³ Gerald Corrigan, President of the New York Fed, has presented his own detailed restructuring plan that restricts bank holding companies to offering financial services. On the other hand, the Federal Deposit Insurance Corporation (FDIC) has proposed that bank holding companies be free to offer a full range of financial and nonfinancial services. Under that plan, General Motors could own a bank subsidiary or Citicorp could own an automobile factory.

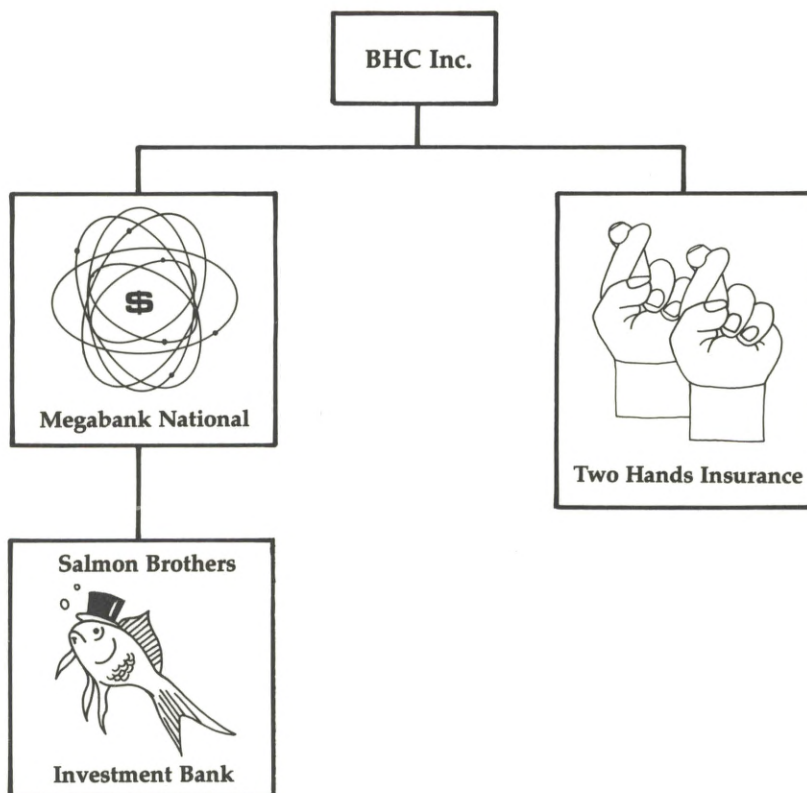
Where Can Nonbank Activities Be Carried Out Inside the Bank Holding Company? Anyone

who has examined the organizational chart of a large company knows that internal organizational structures can be quite complex. (See AN IMAGINARY HOLDING COMPANY, p. 8.) With expanded powers, bank holding companies might choose a number of different ways to provide nonbanking services. Take the hypothetical example of a holding company that wishes to provide both commercial banking services and underwriting of securities. The holding company could create two separate subsidiaries, a commercial bank subsidiary and an investment bank subsidiary. Each subsidiary would be separately capitalized and have its own management. Or, the holding company could set up a commercial bank subsidiary which provides investment banking activities through its own investment bank subsidiary. That is, the holding company owns the commercial bank, which in turn, owns the investment bank. Finally, the holding company could simply create a single subsidiary that provides both services, perhaps in separate departments.

Although there are some analysts who would

³Actually, "banking" and activities "closely related to banking" as defined by regulators are not all financial services. The distinction between financial and nonfinancial activities, however, is a close approximation to the distinction between banking and commerce.

An Imaginary Holding Company



BHC Inc. illustrates a holding company structure that might arise if bank holding companies were permitted to offer underwriting and insurance services and if they were free to choose their own internal organization. The *parent company*, BHC, owns stock in its two subsidiaries: a *bank subsidiary*, Megabank National, and a *nonbanking subsidiary*, Two Hands Insurance. Normally, BHC will hold a large share of its subsidiaries' equity, because there are substantial tax benefits if the parent owns at least 80% of a subsidiary's stock. Megabank also has its own subsidiary, an investment banking firm, Salmon Brothers. The bank owns stock in Salmon Brothers, just as BHC owns stock in the bank and the insurance company. BHC and Two Hands Insurance are both *nonbanking affiliates* of Megabank. Megabank's own subsidiary, Salmon Brothers, is also considered a nonbanking affiliate of the bank.^a

^a Megabank might also have affiliates outside of the holding company. Under Section 23a of the Federal Reserve Act, the Federal Reserve System has substantial discretion in defining an affiliate. If business dealings between a bank and another firm are not "at arm's length," the Fed considers that firm an affiliate of the bank.

leave the bank holding company free to make any of these choices, none of the major restructuring proposals advocates the third possibility.⁴ The major proposals are, however, divided between those which would permit banks to own nonbanking subsidiaries and those which would require that nonbanking services be provided through subsidiaries that are managed and capitalized separately from bank subsidiaries. President Corrigan, in his own proposal, and Chairman Greenspan, speaking for the Fed, have taken the approach that banking and nonbanking activities should be housed in separate subsidiaries of the holding company. The Comptroller of the Currency has taken the less restrictive stance that bank holding companies should be free to choose either organizational form. The FDIC, while nearer to the Comptroller's position, has agreed that separate subsidiaries might be required for some activities that regulators deem to be especially risky.

What Parts of the Bank Holding Company Should Be Regulated By Bank Regulators? On this question, the proposals are divided between those that advocate consolidated regulation of the bank holding company and those that would have bank regulators oversee just the bank subsidiaries of the holding company.

Consolidated regulation can mean different things to different people. In the official Fed position, consolidated regulation, at the minimum, would permit the bank regulator to set capital requirements for the parent company as well as for its bank subsidiaries.⁵ The Corrigan proposal

takes a more expansive view of the supervisory powers of the holding company's regulator. In his proposal, the holding company's regulator could also set capital requirements for and exercise "prudential supervision" over each component part of the holding company. Thus, a separately capitalized investment banking subsidiary of the holding company would be subject to direct oversight by a bank regulator.

Both the FDIC and the Comptroller take a narrower view of bank regulators' oversight role. Specifically, bank regulators would set standards—like capital requirements and portfolio restrictions—for the bank, but not for the holding company or for any of the nonbanking subsidiaries of the holding company. The bank's regulators would, however, set and enforce rules governing relations *between* the bank and its nonbanking affiliates: the parent company, the nonbanking subsidiaries of the holding company, and the subsidiaries of the bank. For example, bank regulators would set rules limiting lending by the bank to an insurance affiliate or to the parent company.

The Root of the Differences. If we step back for a minute, we can see that the proposals' answers to each of the questions are linked. Proposals requiring strictly separate nonbanking affiliates also call for consolidated supervision of the holding company—the Corrigan view and the Fed view. Proposals granting bank holding companies more freedom to choose how to offer nonbanking activities do *not* call for consolidated supervision—the Comptroller and the FDIC view. And those who demand tighter restrictions on holding company organization and require consolidated supervision would also permit bank holding companies to offer fewer nonbanking services.

But how are the answers to these very different questions linked? The most important reason why President Corrigan and the Fed answer one

⁴Analysts who advocate the third possibility believe that existing restrictions on interaffiliate transactions are a feasible alternative to restrictions on organizational choice. See, for instance, Anthony Saunders, "Bank Holding Companies: Structure, Performance, and Reform," in William Haraf (ed.) *Restructuring the Financial System*, American Enterprise Institute, Washington, D.C. (forthcoming).

⁵The recent Fed interpretation of its traditional position that the holding company should act as a "source of strength" to its bank subsidiaries implies an even stronger role for the consolidated capital of the bank holding company. Under the source of strength doctrine, regulators can require the

holding company to provide financial support to a weakened or failing bank subsidiary when the holding company is in a position to do so.

way and the FDIC and the Comptroller another is that they have different views about the possibility of insulating the bank from nonbanking affiliates within the holding company. Both President Corrigan and the Fed believe that insulation of the bank is quite difficult to guarantee, while both the FDIC and the Comptroller are more optimistic about the feasibility of insulating the bank.

INSULATION OF THE BANK: THE KEY TO THE DEBATE

What Does Insulation Mean? In the debate over regulatory reform, the idea of insulating the bank has paraded under a number of colorful phrases such as the creation of “Chinese walls” or “fire walls” between the bank and its nonbanking affiliates. Whichever term is used, the basic idea is that the safety net, which necessarily includes government guarantees to the bank and its depositors, should not be extended to nonbanking affiliates within the holding company.

In normal times, when the bank and its affiliates are financially healthy, insulation means that the holding company cannot use the bank to subsidize nonbanking activities. For instance, the bank might conceivably pay out “excessive” dividends to the parent company, which then reinvests these funds in an insurance subsidiary. These transfers may weaken the bank financially, but some of the increased risk is borne by the FDIC, which generally guarantees the bank’s depositors against loss. This type of policy, in effect, transfers the benefit of the government guarantees for bank depositors to the insurance affiliate.

In times of crisis, when either the parent company or a nonbanking firm in the holding company is financially troubled, insulation means that neither the bank nor bank regulators will prop up the affiliate. Suppose a real estate investment affiliate’s investments have shaky foundations and are beginning to fall in value. The parent company might direct the bank to make loans to the real estate affiliate, even though

these loans would normally be considered excessively risky. Should these loans threaten the health of the bank, bank regulators might step in to save the bank, effectively passing on losses from the real estate affiliate to the FDIC. An insulated bank would neither subsidize its affiliates nor prop up affiliates in trouble.⁶

Why Is Insulation the Key? Suppose banks can be insulated effectively from their nonbanking affiliates. In that case, a whole host of problems disappear. There is little danger in permitting bank holding companies to offer a wide range of nonbanking activities. For example, regulators need not worry that the highly cyclical demand for automobiles could lead to periodic problems for the bank subsidiary of a holding company that also produces cars. The parent company can also be given substantial freedom in choosing its own internal organizational structure. If loans and other types of financial transfers between a bank and a real estate subsidiary of the bank can be easily monitored and controlled, then it makes little sense to force the holding company to house banking and real estate activities in separately managed subsidiaries. The holding company can choose the most efficient organizational form without endangering the banking system or extending the safety net to the real estate industry. Finally, bank regulators will not need to supervise the holding company or its nonbanking subsidiaries. Regulators can direct their attention to the bank alone

⁶Although this account stresses the importance of the behavior of holding company management and regulators for ensuring insulation, the beliefs of the public—investors and customers of the bank and its affiliates—and the willingness of the courts to enforce the doctrine of corporate separateness are also important. The debate over insulation is closely related to the debate over so-called conflicts of interest. Both among regulators and academics, there is substantial disagreement about the incentives for holding companies to weaken the financial condition of the bank, even in the absence of regulatory safeguards to ensure insulation. See Anthony Saunders, “Securities Activities of Commercial Banks: The Problems of Conflicts of Interest,” this *Business Review* (July/August 1985) pp.17-27, for a complete discussion of these issues.

and permit the nonbanking affiliates to make unfettered business decisions, risky or otherwise. Insulation guarantees that risky or imprudent decisions by a nonbanking affiliate will not increase the bank's risk or the regulator's exposure. None of this is true, however, if the bank cannot be insulated or if the regulatory costs of ensuring insulation are too large.

IS INSULATION POSSIBLE?

If Bank Holding Companies Are Highly Integrated, Insulation Is a Bigger Problem. The organizational chart of a holding company provides only a partial picture of the way the business is actually run. Consider the example of a hypothetical holding company, BHC Inc., which owns just two subsidiaries, a bank and an insurance company. This organization might be run in many different ways. One extreme possibility is that BHC Inc. leaves the two subsidiaries alone to make all important business decisions, such as how profits are to be used, which investments should be made, and which new markets should be entered. In this case, BHC Inc.'s managers act like passive investors owning a two-firm portfolio. They might act this way if the sole reason for investing in both the bank and insurance companies were to diversify, that is, to reduce fluctuations in the returns on their total investment.

At the other extreme, BHC might centralize all decisionmaking at the holding company level. BHC might decide how all profits made by the bank and the insurance company should be reallocated between the two companies, which types of investments should be made by each, and which new markets should be entered. In this case, the entire holding company is operated as a single consolidated organization.

While these extreme cases are unrealistic, they help to illustrate the connection between the level of integration of the holding company and the possibility of insulating the bank. If a bank holding company is merely a portfolio of completely independent firms, then the bank is clearly insulated from both the parent and the

insurance affiliate. Without direction from BHC, the bank acts exactly like a bank without any affiliates. If, however, all decisionmaking is centralized, then situations may arise where BHC's management views the profitability and safety of its bank subsidiary as a secondary concern, less important than the profitability of the holding company as a whole. Also, bank regulators will find it difficult to separate the affairs of the bank and its affiliates should the holding company experience financial difficulties.

The empirical evidence about how bank holding companies are actually run suggests that they are not merely portfolios of independently run firms.⁷ For instance, banks inside holding companies normally pay out more dividends and hold less capital than independent banks.⁸ Survey evidence shows that parent companies centralize some decisions but not others. Gary Whalen finds that parent companies often set dividend payments by bank subsidiaries and make other capital management decisions like how external funds should be raised.⁹ In

⁷See Anthony Cornyn, Gerald Hanweck, Stephen Rhoades, and John Rose, "An Analysis of the Concept of Corporate Separateness in BHC Regulation from an Economic Perspective," *Proceedings of A Conference on Bank Structure and Competition*, Federal Reserve Bank of Chicago (May 1986); Timothy Hannan, "Safety, Soundness, and the Bank Holding Company: A Critical Review of the Literature," Working Paper, Board of Governors (1984); and Anthony Saunders, "Bank Holding Companies: Structure, Performance, and Reform," for reviews of the empirical literature.

⁸This does not necessarily mean that banks inside holding companies are being used to subsidize affiliates or that they have a greater risk of failure. In part, dividend payments are used to retire holding company debt used to purchase the bank. While lower capital, by itself, tends to increase the bank's risk of failure, the bank's expected profits and the variability of profits must also be considered. Empirical studies of the risk of failure for banks in holding companies have reached varying conclusions.

⁹Gary Whalen, "Operational Policies of Multibank Holding Companies," Federal Reserve Bank of Cleveland, *Economic Review* (Winter 1981/82). For the most part, empirical studies have concentrated on the relationships between the parent company and its bank subsidiaries. Evidence about the degree of coordination of banking and nonbanking activities by the parent company is scanty and anecdotal.

addition, parent companies often have the final say over major investment decisions by bank subsidiaries. On the other hand, Whalen finds that the parent company is likely to leave portfolio management decisions and pricing decisions to its bank subsidiary.

Since the degree of integration of bank holding companies appears to be substantial, insulation of the bank may be a problem. But bank regulators need not be, and are not, helpless observers, whose only tools for influencing the behavior of bank holding companies are a wish and a prayer. And strict limitations on permissible products and services, extensive restrictions on organizational structure, and consolidated supervision are not the only regulatory alternatives.

Existing Regulatory Safeguards Enhance Insulation . . . Among the safeguards that are already in place, perhaps the two most important are the restrictions on interaffiliate transactions written into Section 23 of the Federal Reserve Act, and regulatory capital requirements for banks. The FDIC proposal, in particular, lays great stress on these regulatory safeguards as a workable alternative to more extensive regulation of bank holding companies.

Sections 23a and 23b of the Federal Reserve Act are designed to limit a bank's exposure to its nonbanking affiliates and to prevent a bank holding company from using its bank subsidiary to subsidize nonbanking activities. Section 23a places quantitative limits on financial transactions between a bank and its affiliates, including loans, equity investments, and certain types of guarantees such as letters of credit.¹⁰ To see how these limits work, consider BHC Inc. again and imagine, for simplicity, that the only types of internal financial transactions are loans from the bank to BHC Inc. and its insurance subsidiary. Under Section 23a, bank loans to either affiliate

could not exceed 10 percent of the bank's capital. Further, the total loans made by the bank to both its affiliates together could not exceed 20 percent of the bank's capital. Thus, in the extremely unlikely event that both the parent company and the insurance company were unable to repay any of their loans, the most the bank would stand to lose is 20 percent of its capital, a painful, but not necessarily fatal, loss as long as the rest of the bank's portfolio is healthy. Of course, a 20 percent decline in the bank's capital is no trivial matter, but recent evidence from a study at the Board of Governors of the Federal Reserve System suggests that, in practice, banks do not approach the regulatory limits.¹¹ In fact, the Board study shows that net financial flows from banks to their affiliates tend to be negative; that is, funds flow from the affiliates to the bank rather than the other way around.

Section 23b requires that any transactions between the bank and the insurance affiliate must be on terms at least as favorable to the bank as a similar transaction with an insurance company outside the holding company. Thus, if the bank would demand a 10 percent rate of interest on a one-year loan to a nonaffiliated insurance company, it could demand no less from the insurance subsidiary of BHC Inc.

Of course, regulations are only as good as the information available to regulators. Unless bank regulators have timely and accurate information about financial flows between banks and affiliated companies, they cannot be sure that attempts to breach restrictions will be caught in time. All of the restructuring plans agree that more stringent and detailed reports from banks about transactions with affiliates are a necessary price to pay for

¹⁰See "The Banking Affiliates Act of 1982: Amendments to Section 23a," *Federal Reserve Bulletin* (November 1982) for a more detailed description of Section 23a.

¹¹See John Rose and Samuel Talley, "Financial Transactions Within Bank Holding Companies," Staff Study #123, Board of Governors (May 1983). Their results are only suggestive, because they do not include all types of financial flows. Also Section 23a limits do not net out offsetting financial transactions between the bank and its affiliates. It is possible for the bank to make loans to affiliates equal to 20% of its capital yet still have a *net* inflow of funds.

permitting bank holding companies to offer more nonbanking services.

Minimum capital requirements for banks also insulate the bank from its affiliates' financial losses, because capital serves as a cushion against potential losses. In fact, capital standards serve a double duty in this regard, because the quantitative limitations in Section 23a are all expressed as fractions of the bank's capital. A bank without much capital faces severe limits on the dollar value of loans or guarantees to its affiliates. If the bank is pressing against its limits, yet wishes to expand financial transactions with affiliated firms, it must increase its capital, perhaps by selling new equity.

If bank capital cushions the bank and the FDIC against losses, won't additional capital requirements for the parent company or nonbanking subsidiaries of the holding company work even better? It is true that the FDIC's potential losses are smaller if the consolidated organization has a larger capital cushion. However, it doesn't necessarily follow that any additional capital should be held by the parent company or other nonbank subsidiaries, as long as bank regulators enforce capital requirements for each bank stringently. Requiring holding company capital to serve as a backup for bank capital only makes sense if regulators believe that banks in holding companies are riskier than independent banks. But if there is reason to believe that banks inside holding companies should hold more capital than independent banks, then an alternative is for regulators to impose a supplemental requirement on the banks directly, rather than on the parent company or nonbanking subsidiaries. This alternative approach would not only be more direct but would also be more consistent with the principle of functional regulation.

. . . But Insulation Is Possible Only if Regulators Will Keep the Bank Separate. Inevitably, situations will arise where the parent company or a nonbanking affiliate is in serious financial trouble, while the bank is financially healthy. Much of the debate about the feasibility of insulation has focused on the behavior of the

holding company's management in these situations. Equally important—maybe more so—is the behavior of bank regulators. If regulators feel compelled to extend guarantees to troubled affiliates out of fear that the public will lose confidence in the bank when an affiliate fails, then insulation is not feasible.¹²

The regulator might reason that since a troubled nonbanking subsidiary and the bank are part of the same organization, the public will interpret troubles in the nonbanking company as evidence of weak management of the holding company and, in turn, of the bank. If regulators, who by nature take a wary and conservative view of the dangers of financial instability, do reason this way, then public pronouncements that the safety net will not be extended to nonbank activities are not credible. And if regulators cannot credibly commit to separate the bank from its troubled affiliates, then the holding company management won't take as seriously regulatory restrictions designed to keep the bank separate.

The credibility of regulators' commitment not to extend guarantees to nonbanking affiliates also will depend on how the financial and regulatory system is restructured. A bank regulator who supervises the holding company on a consolidated basis may have considerable power to intervene to save a struggling nonbanking affiliate. The consolidated supervisor of the holding company might be sorely tempted to devise complicated recovery plans involving transfers between the firms in the holding company to save the organization from failure. On the other hand, a regulator whose supervisory role is limited to setting standards for the bank alone will have fewer options to extend guarantees to nonbank affiliates.

One likely effect of expanded powers for bank

¹²See Anthony Cornyn, et. al., "An Analysis of the Concept of Corporate Separateness..." pp.185-191, and Anthony Saunders, "Bank Holding Companies: Structure, Conduct and Reform," pp. 32-37, for contrasting readings of the empirical evidence about public attitudes.

holding companies is the emergence of larger organizations, which will also affect the options facing regulators. This development cuts two ways. In general, regulators are much more concerned about the potential failure of a large banking organization than a small one, because the disruptive effects to the financial system of the failure of a large organization are more widespread. Commitments to keep the bank separate when a very large bank holding company is on the edge of collapse may be very difficult to honor. But the emergence of larger banking organizations may also mean that there will be more firms that could purchase a bank from a financially troubled holding company. The greater the number of firms that can afford to purchase the bank, the more credible regulators' commitment to keep the bank separate from the holding company's problems.

CONCLUSION

Diverse as the recent proposals for restructuring the financial system are, they agree on some basic principles: bank holding company powers should be expanded, functional regulation is desirable, and a strictly limited safety net for banks should be maintained. How far powers should be expanded, how bank holding companies should be organized, and how much of the bank holding company should be supervised by bank regulators are the major sources of disagreement. These disagreements flow in large part from different beliefs about the possibility of insulating the banks from their affiliates.

Whether banks can be insulated is a complicated, and unresolved, issue. The effectiveness of Section 23a and 23b restrictions have yet to be tested in an environment where bank holding companies engage in a wide range of financial, and perhaps nonfinancial, services. Whether regulators can keep the bank separate and avoid extending the safety net to nonbanking affiliates in large bank holding companies is another open question. Bank regulators' behavior since the rescue of Continental Illinois Bank, however, does provide some evidence on this issue. In recent years, regulators have gained substantial experience in dealing with large troubled banking organizations, especially in Texas and Oklahoma. For the most part, regulators have avoided bailing out parent companies when the troubled banks were reorganized or sold.¹³

Ultimately, debates over economic issues inform but don't dominate the course of legislative reform. Self-interested industry groups will all have their say, and legislators and regulators are unlikely to ignore their pleas. As the banking bills now winding their way through the House and Senate show, restructuring will occur in fits and starts and will not be as coherent as the formal plans that have been presented. Public debate over the economic issues, however, can only improve the coherence of regulatory reform as it unfolds.

¹³See FDIC, "Mandate for Change..." for a summary of regulators' experience with bank failures since Continental Illinois' rescue.

Thinking About The Deductibility of State and Local Taxes

*Harvey S. Rosen**

INTRODUCTION

Through most of its history, federal tax law has allowed itemizers to deduct state and local property, income, and general sales taxes. Data provided by the Executive Office of the President estimated that this provision decreased federal tax revenues by about \$30.8 billion in 1985. Over the last several years, Congress, the President, and the people have debated the merits of partially or totally eliminating state and local tax deductibility. The U.S. Treasury

recommended complete abolition of deductibility in 1984, as did President Reagan in 1985. However, those who favored deductibility argued that its elimination would have a disastrous impact on state and local public finance. In this view, if people could not deduct state and local taxes on their federal tax returns, then they would vote to reduce these taxes. State and local public officials appear to believe this scenario. When the United States Conference of Mayors convened in 1985, the *New York Times* reported that the meeting "... ended with an unusual display of bipartisan unanimity: only one 'no' vote was audible on a resolution urging Congress to amend the [President's] tax plan to keep

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deductibility of state and local taxes"¹

The landmark Tax Reform Act of 1986 embodied a compromise on this issue. It disallowed deduction of state sales taxes, but continued those for income and property taxes. More changes in the tax code are likely in the next few years, and state and local tax deductibility will probably remain a controversial issue.² In analyzing this controversy, two main questions arise. First, is it sensible for the tax base of the federal income tax to exclude individuals' payments of state and local taxes? Second, what would happen to state and local revenues and expenditures if deductibility were eliminated? The correct answers to both questions are controversial for two reasons. First, economic theory does not provide firm guidelines as to how "income" should be defined for purposes of taxation. Second, certain data that are required to understand how state and local governments react to changes in the federal tax structure are not available.

DO STATE AND LOCAL TAXES BELONG IN THE TAX BASE?

Defining Income. In order to determine whether an individual's state and local tax payments should be *excluded* from his taxable income, we need some kind of criterion for deciding what ought to be *included*. That is, we require a careful definition of "income." Interestingly, the statutes provide no such definition. The constitutional amendment that introduced the tax

merely says "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived." While the tax law does provide examples of items that should be classified as income—wages and salaries, rents, dividends, and so forth—the words "from whatever source derived" do not really provide a standard that can be used to decide whether or not the exclusion of certain items from taxation is appropriate.

Public finance economists have traditionally used their own standard, the so-called *Haig-Simons (H-S) definition*: income is the money value of the net increase to an individual's power to consume during a period.³ This is equal to the amount actually consumed during the period plus net additions to wealth. Net additions to wealth—saving—must be included in income because they represent an increase in potential consumption. The justification for the H-S definition is that an individual's potential consumption is a good measure of his ability to pay taxes, and tax liabilities should be based on ability to pay.

Using this criterion requires including all sources of potential increases in consumption, regardless of whether the actual consumption takes place, and regardless of the form in which the consumption occurs. At the same time, it requires that any decreases in an individual's potential to consume should be subtracted in determining income. For example, if certain expenses have to be incurred to earn income, these should be subtracted. If the gross revenues from an individual's business are \$50,000 but business expenses were \$40,000, then the individual's potential consumption has only increased by \$10,000.

Another important implication of this criterion is that nondiscretionary expenses should be deductible from income. If you have no choice over some expense and it is not contributing to

¹What Happens if Washington Changes the Rules?" *New York Times* (June 23, 1985) p. E5.

²There are also claims that removing deductibility would lead to an unfair increase in the tax burden on middle-income taxpayers. The distributional implications of deductibility, both across states and across income classes, are discussed in Daniel R. Feenberg and Harvey S. Rosen, "The Deductibility of State and Local Taxes: Impact Effects by State and Income Class," *Growth and Change* (April 1986) pp. 11-31, and Daphne Kenyon, "Implicit Aid to State and Local Governments through Federal Tax Deductibility," mimeo, U.S. Department of the Treasury, Office of Tax Analysis (1986).

³Named after Robert M. Haig and Henry C. Simons, economists who wrote in the first half of the 20th century.

your ability to consume, then it should not be included as part of your income for tax purposes. A classic example is extraordinary uninsured medical expenses. Consider the case where two people earn \$60,000 each, and one has had to pay \$20,000 in hospital bills for treatment of a heart attack, while the other has not. Despite the fact that their earnings are equal, their abilities to pay are not. According to the H-S criterion, it would make sense to allow the heart attack victim to deduct his \$20,000 in medical expenses, so that he is treated as if his ability to pay were \$40,000. In fact, U.S. tax law does follow this model; it allows individuals to deduct unreimbursed medical expenses that exceed 7.5 percent of their total incomes.

What does the H-S criterion tell us about the deductibility of state and local taxes? The key question is whether payments of state and local taxes are “like” medical expenses. If they represent nondiscretionary decreases in people’s ability to pay, then they should not be counted as part of income. If, on the other hand, state and local taxes are discretionary, then according to the H-S criterion, there is no reason to permit an individual to deduct them.

Are State and Local Taxes Discretionary?

Suppose that people have no control over their state and local taxes, and they reap few benefits from these taxes. Then, according to the H-S definition, state and local taxes are nondiscretionary and ought to be deductible. This view is quite a popular one. For example, during the public debate over deductibility, people from high tax states like New York argued that it would be “unfair” to disallow deductibility, because they would be hurt compared to citizens of low tax states (like New Hampshire). Implicit in this view is that New Yorkers do not derive much benefit from their taxes. Otherwise, why should the taxes be regarded as a burden that reduces their ability to pay?

A very different view of state and local taxes was espoused by economist Charles Tiebout (rhymes with “me too”) in an article published in 1956. To understand Tiebout’s hypothesis, it

helps to begin by thinking about the options available to people who disapprove of some action being taken by the U.S. federal government (like giving aid to the Contras or funding Planned Parenthood). Only in extreme cases do we expect people to leave the country because of federal government policy. Because of the large monetary and psychic costs of emigrating, a more realistic option is to stay home and try to change the policy. On the other hand, most citizens are not as strongly attached to their local communities. If you dislike the policies being followed in Ardmore, Pennsylvania, the easiest thing to do may be to move a few miles away to Haverford.

Tiebout argued that people take advantage of their mobility to “vote with their feet” and locate in the community that offers the bundle of public services and taxes they like best. Much as a person satisfies his desire for private goods by purchasing them on the market, he satisfies his desire for publicly provided goods like education by the appropriate selection of a community in which to live. The taxes he pays are simply fees for these goods. Ultimately, according to Tiebout, people distribute themselves across communities on the basis of their demands for publicly provided goods. Each individual receives his or her desired level of these goods and cannot be made better off by moving (or else the individual would).

If Tiebout’s view of the world is correct, there is no more reason to allow an individual to deduct his state and local taxes than there is to deduct his expenditures on cottage cheese. Both represent payments for something the individual wants.⁴

⁴Another assumption of the Tiebout model is that spending in one community affects the welfare only of its own members. If there are beneficial spillover effects, then deductibility might be viewed as a way to encourage such desirable activities. However, a more efficient way to do this is for the federal government to provide matching grants for the relevant activities.

Tiebout's provocative hypothesis has stimulated a huge amount of research. Some of this research has criticized his model for being based on unrealistic assumptions. For one thing, people are not perfectly mobile; they are attached to communities by jobs, personal ties, and other commitments. Even if people could move around costlessly, there are probably not enough communities so that each family can find one with a bundle of services that suits it perfectly. Moreover, contrary to what the Tiebout model implies, we observe many communities within which there are massive income differences and hence, presumably different desired levels of public goods provision. Just consider any major city.

However, we should not dismiss the Tiebout mechanism too hastily. There is a lot of mobility in the American economy. A persistent pattern is that in any given year, about 17 percent of Americans have residences different from those they had the year before, according to the U.S. Bureau of the Census. Moreover, within most metropolitan areas, there is a wide range of choice with respect to type of community. In the Philadelphia metropolitan area alone there are some 300 municipalities from which to choose. Certainly, casual observation suggests that across suburbs there is considerable residential segregation by income, and that exclusionary zoning is practiced widely. In addition, it is not hard to find popular accounts of classic Tiebout-type behavior. Recently in California, for example, a number of communities voted to increase their taxes in order to pay for more police protection.

Where does this leave us? The Tiebout model is quite relevant for people who live in suburban settings, but for citizens of big cities it does not seem to apply. And it is surely stretching the theory to argue that it is relevant to an individual's choice of a state (as opposed to a community). It would be nice to know what proportion of state and local taxes can properly be regarded as Tiebout-type user fees, but such data are not available. Therefore, we are left concluding that the question of whether state and local taxes should be included in the tax

base does not have a clear answer.

Legislators, of course, have to go ahead and make decisions even when these issues are unresolved, as the recent Tax Reform Act attests. The reform eliminated deductibility for state sales taxes but retained it for local property taxes. If the H-S criterion guided this choice, then legislators must have believed that sales taxes are more like discretionary user fees than are property taxes. However, since it is easier to move from one nearby community to another than from one state to another, it is likely that just the opposite is the case.

Regardless of how one comes down on this question of what should or should not be deductible, it is still important to know how state and local public finance would react if deductibility were eliminated. Indeed, even if one believed, based on the Haig-Simons point of view, that the deduction should be removed, doing so might not be socially desirable if it leads to drastically reduced revenues for state and local governments. Economists have approached the issue of measuring the effects of removing deductibility in a number of ways, and they have come up with differing answers. We can begin to sort through these results by analyzing the impact of removing deductibility when all state and local taxes are levied on households, and then turn to the complications that arise when businesses are taxable as well.

HOW DEDUCTIBILITY AFFECTS INDIVIDUALS' AND COMMUNITIES' DECISIONS

In a world in which the Tiebout model held exactly, everyone in a community would want the same amount of public spending. This, however, is not a good description of reality. Within a community, generally there is some disagreement about the best level of public expenditure. Therefore, some kind of public choice process is required to take the citizens' preferences and translate them into a decision for the community. In the current context, this suggests that thinking about the impact of removing deductibility on

public spending requires two steps. The first is to find out how removal affects each individual's demand for public expenditure; the second is to determine how these changes translate into a collective decision.

The Individual's Decision. What factors determine how much public expenditure an individual citizen demands? For concreteness, think about the commodity "public education." Like any other commodity, the quantity that a person demands depends on his income, the price per unit of education, his demographic status (children or not), and so forth. As the price per unit of education and the individual's income change, so does the amount of his desired level of public expenditure on education. In particular, other things being the same, when the price goes up, the quantity desired by the individual decreases by some amount. This observation is crucial because there is a direct link between the individual's price for publicly provided goods and the deductibility of the taxes used to finance them. To see why, consider Smith, whose marginal federal income tax rate is 28 percent, and who itemizes deductions on her income tax return. Then each dollar of taxes that Smith pays for state and local expenditure costs her only 72 cents. Why? Because state and local taxes are deductible, each dollar of these taxes lowers her taxable income by one dollar. Given a 28 percent tax rate, one dollar less of taxable income saves Smith 28 cents in taxes. Hence, the effective price of one dollar of public expenditure is one dollar minus 28 cents, or 72 cents. More generally, for an itemizer, the "effective price" of a dollar of state or local public expenditure is one minus her marginal tax rate.

Suppose now that deductibility were eliminated. How would this affect Smith's demand for local public goods? Without the deduction, each dollar of public expenditure costs Smith exactly one dollar. In effect, then, removing deductibility raises her effective price for a dollar of public expenditure from 72 cents to one dollar, an increase of about 39 percent. Now, assume for illustrative purposes that whenever the price

of publicly provided goods increases by 10 percent, the quantity demanded by Smith falls by 3 percent. (In the jargon of economists, this means that the price elasticity of demand for publicly provided goods is -0.3 .)⁵ Therefore, Smith's demand for public goods falls by 11.7 percent (0.3×39).

To summarize, for an individual who itemizes, the elimination of deductibility raises the effective price (also referred to as the "tax price") of publicly provided goods by an amount that depends on her marginal tax rate. This translates into a decreased demand for the publicly provided good. The precise amount of the decrease depends upon the responsiveness of quantity demanded to a change in price.

Note that for someone who does not itemize, the story is quite different. The elimination of deductibility does not change the effective price of public spending—it is one dollar with or without deductibility.

The Community's Decision. Imagine that deductibility has been eliminated. The itemizers in the community will want less public spending than they did previously, although the amounts will differ from person to person. The demands of non-itemizers will not be affected. What will the community do? The answer depends on how public decisions are made. Although there is no definitive model of how the public decision-making process works, it is still useful to consider one popular view of this process, the "median voter model."

Imagine a community in which decisions on public expenditure are based on majority voting. Each voter has a most preferred level of public expenditure, which is based in part on his effective price of publicly provided goods. The "median voter" is the voter whose preferences are in the middle of the set of all voters' prefer-

⁵For an explanation of the concept of elasticity, see Richard Voith, "Commuter Rail Ridership: The Long and The Short Haul," this *Business Review* (November-December 1987) pp. 13-23.

ences. By definition, as many voters want more expenditure than the median voter as do less. Under a broad set of conditions, the outcome of majority voting reflects the preferences of the median voter. This is called the "median voter theorem." (See THE MAJORITY VOTES WITH THE MEDIAN VOTER.) If the median voter theorem applies, then to determine how the community decision changes when deductibility is removed, all we have to do is find how the median voter's choice changes.

To illustrate, suppose that a community is comprised entirely of itemizers, two-thirds of whom have a marginal tax rate of 28 percent and identical preferences for public goods, while one-third have a marginal tax rate of 33 percent and are similarly identical. In this community, the median voter is one of the taxpayers in the 28 percent bracket. If deductions were removed, the median voter's cost of each dollar of local taxes would go up 28 cents. And if, as in our earlier example, a 10 percent increase in the effective price reduces the quantity of the public good demanded by 3 percent, then the median voter's desired amount of public goods falls by 11.7 percent. If the community's decisions are guided by the median voter rule, community expenditures fall by just that amount.

The analysis increases in complexity when we make the more realistic assumption that not all voters itemize. Indeed, according to the Internal Revenue Service in 1985, only about 39 percent of all tax returns were itemized. As noted above, the elimination of deductibility does not change the effective price for public spending facing a non-itemizer—it is one dollar with or without deductibility. Thus, if community decisions are governed by the median voter model and the median voter is a non-itemizer, then the elimination of deductibility will have no impact on public spending at all.

How likely is the median voter to be an itemizer? The likelihood of voting increases with income, but as income increases, so does the propensity to itemize. Hence, we expect itemizers to vote in disproportionately large numbers,

a conjecture that is borne out by voter surveys.⁶ On this basis, a number of investigators have argued that it is safe to assume that the median voter is an itemizer, and local expenditure would fall if deductibility were eliminated.

BY HOW MUCH WILL LOCAL EXPENDITURES FALL?

For illustrative purposes we assumed that a 10 percent increase in the effective price of publicly provided goods led to a 3 percent decrease in the quantity demanded. In order to get at the actual size of the effect of nondeductibility on local expenditures, investigators have to examine community expenditures, and how they vary with the tax prices their citizens face. In some cases, such calculations have been done assuming that only households are taxpayers; in others, that businesses also pay taxes.

If Only Households Are Taxpayers. Given the median voter rule, a natural statistical strategy is to gather data on the per capita expenditures in a number of jurisdictions, and see how these expenditures vary with the tax prices faced by the citizens in the jurisdictions. (Of course, it is necessary to take into account other factors that might influence the amount of public spending, such as the size of the jurisdiction, its median income, and so forth.) A number of papers have followed this strategy. In one influential study, Martin Feldstein and Gilbert Metcalf found that a 10 percent increase in the tax price leads to about a 5 percent decrease in state and local spending.⁷ For a city like Pittsburgh, for example, whose general government expenditure was \$278 million in 1984, public expenditure would fall by \$13.9 million ($0.05 \times \278 million), if

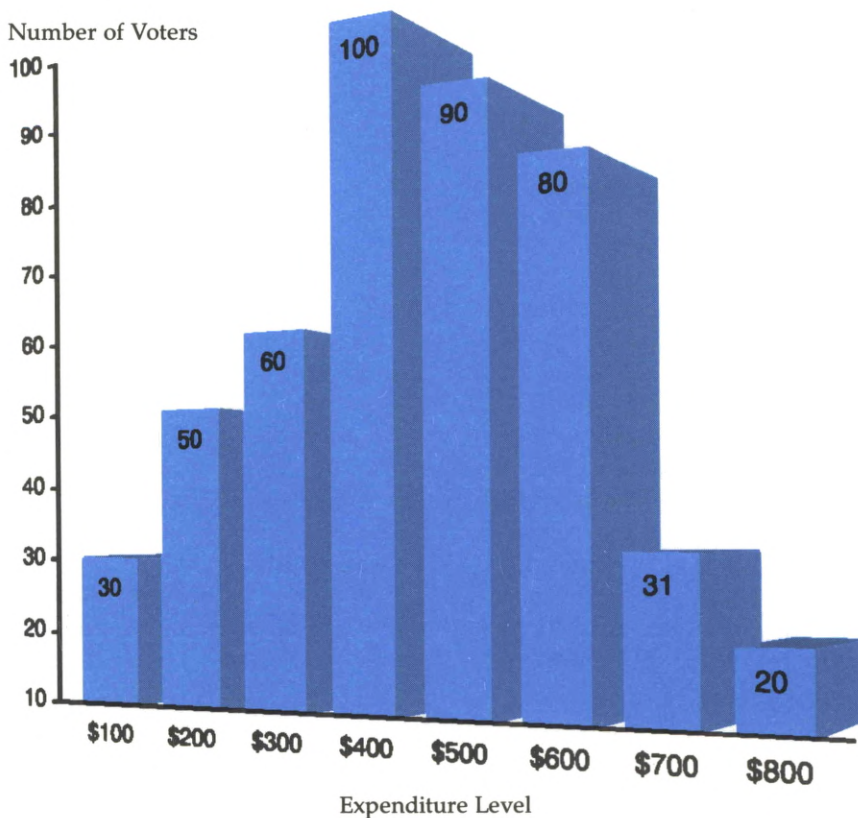
⁶See Helen F. Ladd, "Federal Aid to State and Local Governments," in *Federal Budget Policy in the 1980's*, ed. by Gregory V. Mills and John L. Palmer (Washington, D.C.: Urban Institute Press, 1984) pp. 165-202.

⁷See Martin S. Feldstein and Gilbert Metcalf, "The Effect of Federal Tax Deductibility on State and Local Taxes and Spending," *Journal of Political Economy* (August 1987) pp. 710-736.

THE MAJORITY VOTES WITH THE MEDIAN VOTER

The median voter theorem has a nice graphical representation. In the figure, the horizontal axis indicates the possible public expenditure levels in a hypothetical community with 461 members. The vertical axis shows the number of people in the community who most prefer each expenditure level. For example, 30 people most prefer \$100 worth of expenditure, 50 people \$200 worth of expenditure, and so on. According to the diagram, half the voters (230 people) want \$400 or less of expenditure, and half want \$400 or more. By definition, then, the median voter wants \$400 of expenditure.

Now suppose that there is a vote between a \$400 level of expenditure and any other level, say \$600. Each voter supports the expenditure level that is closest to his or her most preferred level. The \$600 proposal will, therefore win the votes of all people who want \$600 or more, as well as some of the votes between \$600 and \$400. Because \$400 is preferred by the median voter, one half of the voters lie to the left of \$400. Therefore, the \$400 proposal will receive all of these votes and some of those to the right of \$400, guaranteeing this proposal a majority. Given the model's assumptions, no proposal can beat the expenditure level favored by the median voter.



eliminating deductibility increased the tax price by 10 percent.

A problem with Feldstein and Metcalf's analysis is that, from a statistical point of view, their estimates of the impact of the effective price of public spending on fiscal behavior are not very "significant." That is, a very wide range of responses is consistent with the data. Moreover, other empirical studies have obtained different estimates. For example, Douglas Holtz-Eakin and Harvey Rosen found that a 10 percent increase in the effective price would lead to an 18 percent decrease in public expenditure, a rather larger magnitude.⁸ And in this scenario, Pittsburgh's expenditures would fall by about \$50 million (.18 x \$278 million).

Why do the studies differ? There are two major reasons. First, different samples are used. Feldstein and Metcalf consider both states and municipalities; Holtz-Eakin and Rosen look only at municipalities. Second, there are no publicly available data on the actual tax prices in various jurisdictions. Investigators have to try to guess at the relevant tax prices by looking at data on, say, average income in the jurisdiction. Unfortunately, different reasonable procedures for estimating tax prices can lead to quite different substantive results. In short, data limitations have made it impossible to reach a consensus on how much local spending would change if deductibility were eliminated.

If Businesses Also Are Taxpayers. The discussion so far has implicitly assumed that the only sources of state and local revenues are deductible taxes paid by individuals. In fact, governments have access to other sources, such as business taxes. Perhaps the removal of deductibility on individuals' tax returns would merely induce state and local governments to shift more of the tax burden from individuals to firms.

In the same study mentioned above, Feldstein and Metcalf examined the statistical relation between each state's use of business taxes and taxes on individuals that are nondeductible, and the average effective price of public spending in that state. They found that states with higher effective prices do indeed rely more heavily on business and nondeductible taxes. According to their estimates, if deductibility on individual tax returns were eliminated, the increased taxes on businesses and nondeductible sources would tend to counterbalance the decreased taxes from individuals. In other words, ignoring the possibilities for substitution among different revenue sources would lead to serious overestimates of the effect of removing deductibility on state and local spending.

Just as in the case of expenditures, however, there is no consensus on the extent of revenue substitution. Walter Hettich and Stanley Winer used different data and statistical techniques from Feldstein and Metcalf, and estimated that barely any revenue substitution would occur.⁹ In any case, not all communities will be able to substitute business taxes for individuals' taxes to the same degree. Communities with very little commercial property cannot be expected to rely too heavily on business taxation, especially in light of the fact that businesses also can "vote with their feet" if their tax burdens become too onerous.

The possibility that at least some communities can substitute among various tax instruments has important implications for federal tax revenues. From the federal point of view, presumably a major motivation for eliminating deductibility is to increase revenues. However, if removing deductibility would induce states and localities to change their revenue structures along the lines suggested by Feldstein and Metcalf, then the federal government might not

⁸See Douglas Holtz-Eakin and Harvey S. Rosen, "Tax Deductibility and Municipal Budget Structure," NBER Working Paper No. 2224 (April 1987).

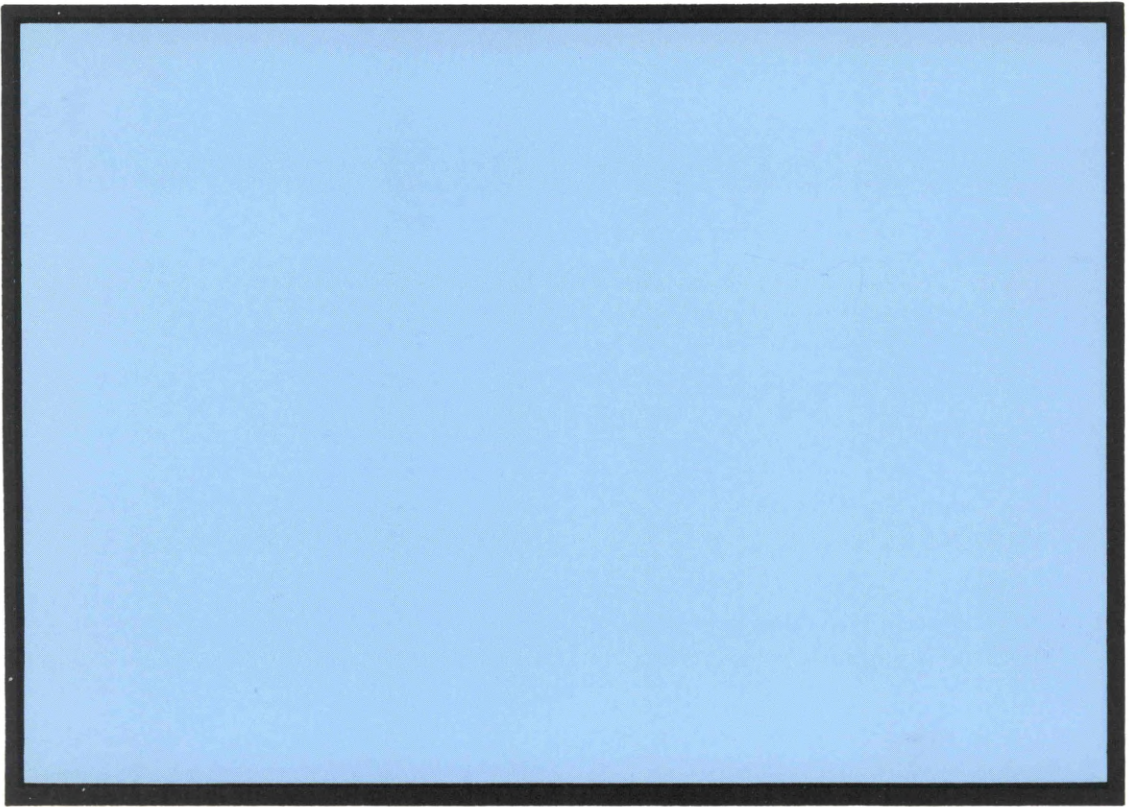
⁹See Walter Hettich and Stanley Winer, "A Positive Model of Tax Structure," *Journal of Public Economics* (1984) pp. 67-87.

gain much revenue from this policy change. The key factor is that businesses would still be allowed to subtract state and local taxes in the computation of their federal taxable income. If businesses have to pay higher taxes to state and local governments, then their net income drops, and their federal tax liability goes down. Thus, while federal personal income tax collections increase, collections from businesses decline. The net effect is hard to predict; Feldstein and Metcalf argue that under certain circumstances, the federal government could even lose money if deductibility were eliminated.

CONCLUSION

The policy debate over the deductibility of

state and local taxes raises two related questions. First, in principle should state and local taxes be included in the base of an income tax system? Second, if deductibility were eliminated, what would be the impact on state and local public finance? The answers to both questions are inextricably linked to the issue of how public sector taxes and expenditures are determined. Unfortunately, there is no consensus on the nature of the decisionmaking process of state and local governments. Nevertheless, the research does suggest that we can reject two extreme views: that removing deductibility would have no effect at all, and that it would decimate the state and local public sector.



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